No. 20897

IN THE UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

LEONARD LUNDGREN and EVELYN R. LUNDGREN,

Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Appellee.

APPELLANTS' BRIEF

Appeal from the Tax Court of the United States

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CASES

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STATEMENT OF JURISDICTION

This is an appeal from a decision of the Tax Court of the United States affirming a determination of the Commissioner of Internal Revenue which asserts a $25,040.01 Federal income tax deficiency against petitioners for the calendar year 1961 rather than allowing a $20,192.40 refund claimed by petitioner. Such decision of the Tax Court also nullifies a refund claim filed by petitioner for 1958 attributable to an operating loss carried back from 1961. If petitioners are entitled to a 1961 business bad debt deduction in the amount of $129,000, there is no deficiency for 1961, and the refunds will be allowed as claimed.

Appellate jurisdiction and the venue are granted this Court by 26 U.S.C.A., Sec. 7482(a) and 7482(b)(1). The Tax Court had the jurisdiction by virtue of 26 U.S.C.A., Sec. 7442.

STATEMENT OF THE CASE

Leonard Lundgren and Evelyn R. Lundgren, husband and wife, are residents of Oregon. Evelyn R. Lundgren is a party to the proceedings only because she filed a joint income tax return with Leonard Lundgren.

Petitioners are entitled to deduct the $129,000 from ordinary income under the bad debt provisions of Sec. 166, provided the debt escapes classification as a nonbusiness debt. Sec. 166 (d)(2) defines a nonbusiness debt as follows:

> "...the term 'nonbusiness debt' means a debt other than -
>
> (A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or
>
> (B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

The Tax Court held the advances of $144,968.55 were "nonbusiness debts", and the Tax Court expressed doubt as to whether the advances constituted genuine indebtedness as contrasted to equity capital. There is no controversy concerning the facts set forth below. They are either direct, or substantially direct, quotations from the stipulation and Tax Court findings, or are based upon uncontradicted testimony. The issues solely relate to the conclusions which should be drawn from the uncontested facts.

The transcript of the record consists of two volumes. Volume I containing the stipulation of the parties and the Tax Court's memorandum findings of fact and opinion is herein referred to as "R". Volume II containing the report of the proceedings before the Tax Court is herein referred to as "Tr", and has been corrected by stipulation (R 66) to delete the term "depreciation" and substitute the term "appreciation" on pages 24, 29, 32, 33, 34 and 49. All the exhibits are joint exhibits of the parties admitted under the stipulation.

Leonard Lundgren (hereinafter called "Petitioner") has been engaged in the timber and lumber manufacturing business during his adult life. He has conducted this business through proprietorships, partnerships and corporations (R 17-18). One of the corporations is RushMore Lumber Company a South Dakota corporation (herein called "RushMore"). Petitioner advanced sums aggregating $144,968.55 to RushMore and in 1961 Petitioner charged off as worthless $129,000 of such $144,968.55. It is stipulated that if the $144,968.55 in advances represent indebtedness rather than equity capital, the advances became worthless during 1961 to the extent of $129,000 (R 18-19).

Prior to the formation of RushMore, Petitioner carried on businesses under the name of Leonard Lundgren Lumber Company, a partnership consisting of Petitioner, his brother, Raymond B. Lundgren, and Orville A. Young (R 19). The partnership was formed in 1951, and prior thereto Petitioner conducted a lumber manufacturing and sales business as a sole proprietorship in and around Bend, Oregon (R 32).

Under an agreement dated February 15, 1956 (Exh 2-B), all of the assets of the partnership, Leonard Lundgren Lumber Company, were transferred to two corporations. The major portion of the partnership assets (subject to all the liabilities) were transferred to Lelco, Inc.; and the balance of the partnership assets consisting of a portable sawmill and related property were transferred to RushMore for $100,000 aggregate par value of RushMore common stock. The RushMore stock (as well as the Lelco, Inc. stock) was issued to the partners in proportion to their partnership interests: Leonard Lundgren 70%, Raymond B. Lundgren 20% and Orville A. Young 10% (R 19). The partnership assets transferred to RushMore for the $100,000 in common stock were worth $100,000.[1]

Immediately after transfer of the portable sawmill and related assets to RushMore in exchange for $100,000 of stock, RushMore received an additional $25,000 in cash from the sale of 25,000 shares of capital stock (R 21-22). This gave RushMore $125,000 in capital stock owned as follows:

	No. of Shares $1.00 per Share	Percentage of Ownership
Leonard and Evelyn Lundgren	74,500	59.6%
Raymond L. Lundgren	20,000	16 %
Orville A. Young	11,000	8.8%
Others	19,500	15.6%
Total	125,000	

1 Prior to the Tax Court hearing, the Commissioner questioned whether the assets transferred to RushMore were worth $100,000. Consequently, many of the stipulated facts and much of the evidence were directed to this valuation question. In his Tax Court brief, the Commissioner did not question the $100,000 valuation or press a "thin incorporation" contention. It is assumed that the Commissioner will not question the $100,000 valuation on this appeal, so facts relating to the $100,000 valuation are not presented or discussed herein.

In 1959, RushMore acquired 9,000 shares of stock from certain of the "others" which acquisition increased the percentage interest of the taxpayer and his wife to 65.35%. There have been no subsequent changes in this stock ownership (R 21-22).

The lumber manufacturing activities of the partnership and predecessor proprietorship took place in Oregon. Lelco, Inc. took over and continued the Oregon operations of the partnership, minus the portable sawmill and related assets. The portable sawmill and related assets transferred to RushMore were moved from Oregon to the plant site of RushMore in South Dakota (Tr38-39). The South Dakota venture of RushMore was motivated by Petitioner's belief that a good opportunity existed for the purchase of timber in South Dakota and the resale of the timber by Petitioner to RushMore at a profit. This opportunity was believed to exist because of the lack of competition in the bidding for United States Forest Service timber available in the South Dakota area (Tr 54).

To obtain funds for improving the sawmill, installing dry kilns and a planing mill at its South Dakota site, RushMore filed an application (Ex 5-E) dated July 27, 1956 with the Small Business Administration for a loan of $250,000, repayable over a ten-year period. The SBA loan application contained a number of exhibits. Exhibit 5 to the application was a forecast of cash receipts and disbursements of RushMore for the period July 1, 1956 to June 30, 1957. This forecast showed temporary advances of $115,859 to be made by Petitioner during July, August and September of 1956 which advances (according to the forecast) would be repaid during October, November and

December, 1956, and January, 1957. The forecast further specified the repayment during February, March and April, 1957 of $15,000 in notes owed to Lelco, Inc. and $29,000 in notes owed to Petitioner for advances previously made.

The SBA granted the loan of $250,000 under conditions set forth in a loan authorization. The loan authorization did not approve the requested ten-year repayment term, or approve the projected repayment of Petitioner's $144,859 in advances by May, 1957. Rather, the SBA required repayment of the SBA loan in six years (rather than ten), and required that Petitioner's advances of $144,859 be subordinated to the SBA loan through the execution of a standby agreement (Ex 15-O).

Conditions of the SBA loan authorization were met, and the SBA loan was evidenced by a promissory note for $250,000 dated September 21, 1956 (Ex 9-I) payable in installments of $4,500 per month which included interest at the rate of 6% per annum, with complete payment being due on or before six years from September 21, 1956. The SBA note was secured by a first mortgage (Ex 10-J), and Petitioner guaranteed repayment (Ex 13-M). The loan agreement (Ex 12-L) prohibited RushMore from paying dividends and from making distributions upon or in redemption of its stock.

Advances of $115,968.55 were made by Petitioner pursuant to the SBA loan authorization in addition to the original $29,000. The aggregate advances of $144,968.55 were evidenced by unsecured demand promissory notes bearing 4% interest. Copies of these notes are attached to Exhibit 15-O, the standby agreement executed by Petitioner. The SBA loan application (Ex 5-E) and the

SBA loan authorization (Ex 7-G) referred to Petitioner's advances as loans. The standby agreement (Ex 15-O) refers to Petitioner's advances as amounts owing to Petitioner evidenced by attached copies of the $144,968.55 in notes. A pro forma balance sheet prepared by a representative of the SBA (Ex 6-F, Tr 98) showed Petitioner's advances as liabilities. Nowhere and at no time did Petitioner, the SBA, or anyone else, refer to or regard Petitioner's advances as equity capital or as anything other than debt obligations. The notes were not subordinated by Petitioner to any creditor other than the SBA.

Petitioner thought RushMore had ample equity capital based upon his past mode of operation and past experience in Oregon (Tr 21). The RushMore operation did not commence generating profits with the same facility in South Dakota as had Petitioner's operations in Oregon. What worked out well in Oregon did not work out so well in South Dakota (Tr 25-26). After encountering difficulties in 1956, 1957 and 1958, things began to iron out in 1959 and there was a climb in the lumber market. The fiscal year ended March 31, 1960 was RushMore's best year (Tr 65). Things were going much better in 1960 when, on June 28, 1960, fire destroyed the sawmill and certain related facilities (Tr 65 and R 28). RushMore received insurance proceeds of $124,307.24, for the destroyed assets (R 29). The SBA required that the insurance proceeds be applied against the first mortgage indebtedness (R 29). The SBA was paid in full as shown on Exhibit 28-AB (R 29). The lumber market took a drop in the last quarter of 1960 (Tr65-66). RushMore never resumed operations after the fire (R 29).

Petitioner never sold stock in a corporation which he formed or caused to be formed or in a corporation controlled by him (R 35). The economic benefits which Petitioner sought from his corporations were compensation for services rendered and/or profit from the sale of timber by Petitioner to the corporations. Petitioner realized both of these economic benefits from Lelco, Inc. Over a period of years, Petitioner sold large quantities of timber to the partnership predecessor of Lelco, Inc. and such timber sales were continued to Lelco, Inc. after its formation (R 47). The sales were in Oregon and the business was profitable (R 52). Petitioner received compensation from Lelco, Inc. for services performed as president (R 47). Petitioner also received a salary from Lundgren Sales Corporation (R 47), a corporation formed in 1952, owned by Petitioner and his wife, which sold lumber produced by the partnership until the incorporation of Lelco, Inc. in 1956, and thereafter sold lumber produced by Lelco, Inc. and RushMore. The compensation paid Petitioner by Lelco, Inc. and Lundgren Sales Corporation is set forth on Exhibit 45-AS.

Petitioner did not form RushMore with the intention of selling the stock at a profit or receive any dividends (R 35-36). Petitioner expected to receive the same economic benefits from RushMore as he received from Lelco, Inc. and Lundgren Sales Corporation, - compensation for services rendered and profits from the sale of timber (Tr24, 34). Realization of these economic benefits was suspended by restrictions imposed as conditions to the SBA loan which restrictions and their impact are related in the next two paragraphs.

The SBA loan agreement (Ex 12-E) provided that no compensation of any kind shall be paid to any officers of RushMore without prior written approval of the SBA. This restriction did not prevent Petitioner from being an officer of RushMore or performing services for it. Petitioner was president of RushMore from the time of its formation (Ex 5-E), and Petitioner performed services for RushMore in addition to the services performed for Lelco, Inc. and Lundgren Sales Corporation (R 47). Petitioner intended to take a salary from RushMore after the SBA restriction was removed. (Tr 34).

In anticipation of RushMore's timber needs, Petitioner acquired two Forest Service timber contracts entitling him to purchase approximately 28,000,000 feet of timber in the Black Hills area of South Dakota. Petitioner informed RushMore that he would make this timber available if and when needed by RushMore (Ex 6 to Ex 5-E). It was Petitioner's intention to sell such timber and subsequently acquired timber, to RushMore at the market price when delivered following the pattern employed in the case of the predecessor partnership and Lelco, Inc. which would give Petitioner a profit in the amount of any appreciation in timber values between the date of acquisition and date of sale to RushMore (Tr 23-24, 54). Carrying out of this intention was precluded by an SBA loan requirement that Petitioner sell at his cost the timber covered by the two Forest Service contracts (R 47) and that Petitioner sell any subsequently acquired timber to RushMore at cost (R 52). Because of this SBA restriction, Petitioner had RushMore take

subsequent Forest Service timber contracts in RushMore's own name which saved the paper work of transferring the timber from Petitioner to RushMore at cost (Tr 33-34), but this did not represent a deviation from Petitioner's intention to sell timber at a profit after elimination of the SBA restrictions (Tr 24, 34, 54). It was necessary for Petitioner to become personally liable on the required performance bonds when RushMore took Forest Service timber contracts in its own name (Tr 42, R 44).

The Commissioner presented no witnesses, and no evidence other than the joint exhibits.

Petitioners contend that the Tax Court of the United States erred as follows in denying a business bad debt deduction to Petitioners in the amount of $129,000 for the year 1961:

1. In failing to conclude that Petitioner's activities connected with RushMore constituted the conduct of a trade or business.

2. In failing to conclude that a proximate relationship existed between:

   (i) Petitioner's advances of $144,968.55 to RushMore; and

   (ii) Petitioner's trade or business activities connected with RushMore.

3. In failing to conclude that a proximate relationship existed between:

   (i) Petitioner's advances of $144,968.55 to RushMore; and

   (ii) Petitioner's trades and businesses activities connected with business entities in general or connected with Lelco, Inc. and Lundgren Sales Corporation in particular;

   the Tax Court having recognized that Petitioner's activities in regard to business entities in general, and Lelco, Inc. and Lundgren Sales Corporation in particular, constituted the conduct of trades or businesses.

4. In expressing doubts as to whether Petitioner's advances of $144,968.55 created a genuine indebtedness rather than equity contributions.

Trade or Business -
First Specification of Error

Petitioner contends that his activities connected with RushMore constituted the conduct of two trades or businesses, -

(i) the trade or business of performing services for RushMore as an officer and employee; and

(ii) the trade or business of selling timber to RushMore.

The Tax Court bases its conclusion that Petitioner was not engaged in the trade or business of performing services for RushMore solely upon the fact that Petitioner never *received a salary* from RushMore, the payment of a salary being precluded by SBA first mortgage loan restrictions. The Tax Court bases its conclusion that Petitioner was not engaged in the trade or business of selling timber to RushMore solely upon the fact that Petitioner never sold timber to RushMore *at a profit*, the SBA loan conditions requiring that Petitioner sell timber to RushMore at cost. The conclusion of the Tax Court that there must be some actual income realization before activities warrant recognition as the conduct of a trade or business conflicts with the opinion of this Court in Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963). Under the doctrine of Hirsch v. Commissioner, supra, an activity constitutes the conduct of a trade or business when the dominant intent behind the activity is to *ultimately* make a profit from the activities. Immediate profit is not necessary.

The Tax Court relies upon a quotation from Whipple v. Commissioner, 373 U.S. 193 at 204 (1963) that the taxpayer had not collected a salary and was not owed one. When the Tax Court's quotation from Whipple is viewed in the full context of the Supreme Court's opinion, there is no conflict with Hirsch. Rather, the approaches and conclusions of Whipple and Hirsch are most compatible, both applying similar tests. Both the approaches of Whipple and Hirsch reach the conclusion that activity of a taxpayer connected with his controlled corporation does not constitute the conduct of a trade or business when the sole or primary monetary remuneration sought from the activity is appreciation in value of the stock and dividends upon the stock, - the return of an investor. Expectation of an investor's return did not furnish the primary economic motivation for Petitioner's activities connected with RushMore. As stipulated and found by the Tax Court, Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends. This confirms Petitioner's corroborated testimony that he was motivated by the expectation of ultimately receiving when permitted by elimination of the SBA loan restrictions:

(i) salary for services rendered to RushMore; and

(ii) profit from the sale of timber to RushMore.

Remoteness of the anticipated remuneration becomes a factor only when it casts doubt upon the actuality of the expectation. Everything is motivated by something and the Commissioner has not suggested any motivation other than the abovementioned expectations of Petitioner.

Proximate Relationship - Second and Third Specifications of Error

A proximate relationship exists between a loan and the economic motivation for the loan. In most cases involving loans by stockholders to controlled corporations, the problem is determining the priority between: (i) trade or business motivation, and (ii) motivation attributable to stock investment. Motivation attributable to stock investment is eliminated by the stipulation and Tax Court finding that Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends. With this nonqualifying motivation eliminated, the only motivating candidate is compensation for services rendered and the gain from the sale of timber which Petitioner expected to receive after elimination of the SBA loan restrictions. Where loans are motivated by trade or business considerations with no competing, nonqualifying motivation, the loans are obviously "created in connection with a trade or business of the taxpayer". Nothing more is required to satisfy the nonbusiness debt exclusion under Sec. 166(d)(2)(A).

The preceding argument (encompassing the first and

second specifications of error) primarily concerns the activities of Petitioner connected with RushMore. Petitioner was also active in connection with two other corporations, Lelco, Inc. and Lundgren Sales Corporation. The Tax Court found that Petitioner was engaged in the trade or business of rendering services to Lelco, Inc. and Lundgren Sales Corporation as officer and employee, and the Tax Court found Petitioner was engaged in the trade or business of selling timber to Lelco, Inc. The scope of Petitioner's trade or business activities should be expressed in general terms, - as rendering services as an officer and employee of corporations, and selling timber to entities for profit. When expressed in these general terms, without limitation to any particular corporation or entity, Petitioner's activities in connection with RushMore are just as much within the scope of such trades or businesses as Petitioner's activities in connection with Lelco, Inc. and Lundgren Sales Corporation. Creation of a new corporate employer and creation of a new purchaser for timber augments and expands the trades or businesses of rendering services to corporations and selling timber to entities.

Even if the scope of the trades or businesses in which Petitioner is engaged is limited to rendering services as an officer and employee of Lelco, Inc. and Lundgren Sales Corporation, and limited to the selling of timber to Lelco, Inc., there is a proximate relationship between such trades or businesses and the loans to RushMore.

Debt vs. Equity

Intent has always been the touchstone of this Court's approach to the debt vs. equity issue. When, as here, the transaction is highly documented and the instruments involved are conventional in form with no ambiguities, the best evidence of the intent of the parties is the manifestation thereof contained in the instruments, at least where no conflicting intent is disclosed by the conduct of the parties.

The promissory notes representing Petitioner's advances were conventional in form and subordinated only to the SBA first mortgage. This furnishes strong, if not conclusive, evidence of intent to create an indebtedness. Other documentation likewise supports debt recognition. There is no conflicting conduct of the parties.

Ignoring all the individualized manifestation of intent, the Tax Court applies objective standards of whether an outside source would have made the advances, and whether the advances were put at the risk of the business to a greater extent than the Tax Court deems proper under its version of prudent corporate financing. Such approach of the Tax Court is a warmed over version of the thesis employed in John S. Taft, 20 CCH Tax Ct. Mem. 1135 (1961), which this Court held to be clearly erroneous in Taft v. Commissioner, 314 F.2d 620 (9th Cir. 1963).

FIRST SPECIFICATION OF ERROR

The Tax Court erred in failing to conclude that Petitioner's activities connected with RushMore constituted the conduct of a trade or business.

ARGUMENT

Although the Tax Court found that Petitioner was engaged in the trade or business of rendering services to Lelco, Inc. and Lundgren Sales Corporation as officer and employee (R 50, 52)[2], and engaged in the trade or business of selling timber to Lelco, Inc. and the predecessor partnership (R 50, 52)[3], the Tax Court held that Petitioner

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2 The following cases cited in Petitioner's Tax Court brief support the proposition that the performance of services constitutes the conduct of a trade or business: Folker v. Johnson, 230 F.2d 906 at 909(C.A. 2d Cir. 1956); Pierce v. United States, 254 F.2d 885 (C.A. 9th Cir. 1958), 58-1 USTC para 9470; Trent v. Commissioner, 291 F.2d 669 (C.A. 2d Cir. 1961), 61-2 USTC para 9506.

3 In Jantzer v. Commissioner, 284 F.2d 348 (C.A. 9th Cir. 1960) affg. 32 T.C. 161 (1959) this court affirmed the conclusion of the Tax Court that timber was held primarily for sale to customers in the ordinary course of trade or business where timber from several tracts was sold by a partnership to a controlled corporation. If timber is held primarily for sale to customers in the ordinary course of business, the holder is engaged in the trade or business of selling timber. The fact that the seller may claim capital gain on timber sales under Sec. 631(b) does not affect the conclusion that he is engaged in a trade or business. Regulation 1.631-2(a) expressly relates that capital gain is recognized under Sec. 631(b) regardless of whether timber is property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

was not engaged in any such trades or businesses so far as RushMore was concerned (R 52). This holding was made by the Tax Court despite the following findings in regard to Petitioner's activities and expectations connected with RushMore:

> Petitioner performed services for RushMore (as well as Lelco, Inc. and Lundgren Sales Corporation), and Petitioner would have received a salary from RushMore if it were not for the SBA restriction prohibiting the payment of salaries to officers (R 47).
>
> Petitioner sold two timber sales contracts to RushMore at cost (R 43). These contracts were sold to RushMore at cost (rather than the timber being sold to RushMore at a profit) because of a condition in the SBA loan authorization (R 47). Petitioner hoped to sell timber to RushMore at a profit after retirement of the SBA loan and elimination of the SBA restriction (R 52).

The Tax Court bases its conclusion that Petitioner's activities connected with RushMore did not constitute the conduct of a trade or business solely upon the fact that Petitioner never received a salary from RushMore and never sold timber to RushMore at a profit. The question, then, is whether there must be some actual realization of the motivating monetary remuneration before activities warrant recognition as the conduct of a trade or business? A similar

question was faced by this Court in Hirsch v. Commissioner, 315 F.2d 731 (9th Cir. 1963).

The issue in Hirsch v. Commissioner, supra, was whether executive activities of a corporate officer amounted to the conduct of a trade or business so as to permit deduction of claimed business expenses and deduction of a claimed bad debt. No compensation had actually been received by the executive for his activities. If failure to receive monetary remuneration precludes activities from being considered the conduct of a trade or business, this Court would have so stated in Hirsch. Instead, the following quotation from Hirsch makes it clear that actual realization of the anticipated monetary remuneration is not required if the dominant intent is to ultimately make a profit or income from the activities cited as constituting the conduct of a trade or business (315 F.2d 731 at 736):

> "...While the expectation of the taxpayer need not be reasonable, and *immediate profit from the business is not necessary*, nevertheless, the basic and dominant intent behind the taxpayer's activities, out of which the claimed expenses or debts were incurred, must be *ultimately* to make a profit or income from those very same activities." (emphasis added).

As authority for its holding that the services performed by Petitioner as president of RushMore did not constitute the conduct of a trade or business, the Tax Court relies upon the following quotation from Whipple v. Commissioner, 373 U.S. 193 at 204 (1963):

> "...Nor need we consider or deal with those cases which hold that working as a corporate executive for a salary may be a trade or business, E.g., Trent v. Commissioner, 291 F.2d 669 (C.A. 2d Cir.). Petitioner made no such claim in either the Tax Court or the Court of Appeals and, in any event, the contention would be groundless on this record since *it was not shown that he has collected a salary from Mission Orange or that he was owed one.*" (Emphasis added).

Whipple v. Commissioner was decided by the Supreme Court in May, 1963 after Hirsch v. Commissioner was decided by this Court in March, 1963. Does the above quotation from Whipple overrule the above quotation from Hirsch?

When the Tax Court's quotation from Whipple is viewed in the full context of the Supreme Court's opinion, there is no conflict with Hirsch. Rather, the approaches and conclusions of Whipple and Hirsch are most compatible, both applying similar tests. The issue in Whipple was whether the devotion of substantial time and energies by a controlling stockholder to the affairs of his corporation for the *purpose of receiving an investor's return*, amounts to the conduct of a trade or business. After reviewing the line of cases which holds that investing is not a trade or business, no matter how extensive the activity, the Supreme Court concluded in Whipple that the devotion of time and energies to the affairs of a controlled corporation, no matter how extensive, is not, in and of itself and without more, a trade or business *when an investor's return is the only monetary benefit sought to be derived from*

the corporation as a result of the devoted time and energies.

If the taxpayer in Whipple had contended that an economic motivation was the expectation of compensation for services rendered, such would have conflicted with the basic proposition of Whipple that an investor's return was the only monetary remuneration the taxpayer sought from the corporation as the reward for his devotion of time and energies to its affairs. In the quotation from Whipple cited by the Tax Court, the Supreme Court merely assured itself that the status of the record, rather than oversight, accounted for the taxpayer's failure to make a contention which would have conflicted with the basic proposition. The Supreme Court did not discuss whether the expectation of future compensation for services rendered would have been the equivalent of present compensation actually received. This is understandable because a Court seldom considers the materiality of every eventuality when

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4 The key quotation from Whipple reads as follows (373 U.S. 19 at 202): "Devoting one's time and energies to the affairs of a corporation is not of itself, and *without more* a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. *When the only return is that of an investor,* the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation." (emphasis added)

rejecting the applicability of a contention which a party did not make. Suppose the record in Whipple had established that the economic benefit which the controlling stockholder expected to derive from his activities connected with the corporation were salary for services rendered and profit from the sale of timber to the corporation?

That Hirsch v. Commissioner still represents the law on the subject is confirmed by LaMont v. Commissioner of Internal Revenue (2nd Cir. 1964) 339 F.2d 377. Decided more than an year after the Supreme Court's decision in Whipple, LaMont v. Commissioner cites Hirsch as follows (339 F.2d 377 at 380):

> "While the expectation of profit need not be a reasonable one, and the business need not realize an immediate profit, the activities must be entered into and carried on in good faith for the purpose of making a profit. Hirsch v. Commissioner, supra; Doggett v. Burnett, 62 App. D.C. 103, 65 F.2d 191 (1933)."

Although actual receipt of monetary benefit is not necessary for activities to constitute the conduct of a trade or business, the basic and dominant intent behind the taxpayer's activities must be ultimately to make a profit or income from the activities. In Hirsch, this Court sustained the conclusion of the Tax Court that the taxpayer's activities as corporate executive were not motivated by the expectation of compensation when the business became successful. Rather, the Tax Court found the executive activities were motivated by the taxpayer's extensive bond holdings in the subject corporation, and by the taxpayer's desire of having a supplemental excuse for being in Las Vegas where activities on behalf of the corporation carried the taxpayer.

When a controlling stockholder devotes extensive time and energies to the affairs of his corporation, there may be a natural inference that the monetary remuneration which he expects to derive therefrom is the return of an investor. The return of an investor is gain from disposition of the corporate stock and the receipt of dividends upon the stock. As held by the Supreme Court in Whipple v. Commissioner, supra, if an investor's return is the only monetary benefit sought to be derived from a corporation as the result of the devotion of time and energies to the corporate affairs, such devotion of time and energies is not the conduct of a trade or business because investing is not a trade or business. The same conclusion is reached under the approach of Hirsch. Where an investor's return furnishes the economic motivation for executive activities, the basic intent is not profit or income to be derived directly from such activities through compensation for services rendered. Rather, the basic intent under such an investor's motivation is to derive an indirect benefit through enhancement in value of the stock or dividends thereon.

Expectation of an investor's return in the form of dividends and gain from disposition of RushMore stock did not furnish the dominant economic motivation for Petitioner's activities connected with RushMore. As stipulated and found by the Tax Court, Petitioner had been engaged in the lumber and manufacturing business during his adult life, and in the course thereof had organized and held substantial stockholdings in corporations (R 38). If an investor's return were the monetary benefit Petitioner sought from his corporations, he

undoubtedly would have realized such return sometime during his lifetime. Yet, as further stipulated and found by the Tax Court, Petitioner never sold stock in a corporation controlled by him, and he never received a dividend from any such corporation (R 48). These background facts differ from those in Whipple, where the Supreme Court related that within a three-year period the taxpayer was an original incorporator of seven corporations, and sold his interest in these corporations along with his equity in five others. Understandably, the Court in Whipple found an investor's return was the only return sought by the taxpayer from his activities connected with the corporate borrower. Such facts in Whipple contrasts with the following quotation from the stipulation, incorporated in the Tax Court findings (R 35-36, 48):

> "...Petitioner did not form RushMore with the intention of selling the stock at a profit or receiving any dividends..."

Selling stock at a profit and receiving dividends are the only ways of deriving monetary remuneration from a corporate stock investment. In view of this stipulation, an investor's return was not the primary, much less the only monetary remuneration which Petitioner hoped to derive from RushMore.

Under the doctrine of Hirsch v. Commissioner, personal activity need not generate an immediate profit to constitute the conduct of a trade or business, provided the basic dominant intent is the ultimate realization of gain or income from the activity. In other words, the activity cited as constituting the conduct of a trade or business must be motivated by the ultimate realization of gain or income directly from the

activities. Negation of an investor's return as the economic benefit sought by Petitioner supports Petitioner's testimony that he was motivated by the expectation of ultimately receiving when permitted by elimination of the SBA restrictions: (i) salary for services rendered to RushMore (Tr 34), and (ii) profit from the sale of timber to RushMore (Tr 24, 34, 54). This testimony of Petitioner was corroborated (Tr 79-80, 99). No competing or altruistic motivation has been suggested by the Commissioner.

Hirsch v. Commissioner places no limitation upon how far in the future a person may look for the ultimate realization of the expected profit or income. Remoteness of the anticipated economic remuneration becomes a factor only when it casts doubt upon the actuality of the expectation. There is no room for doubting the actuality of the expectations in the instant case. As related in the preceding paragraph, uncontradicted and corroborated testimony establishes that Petitioner was motivated by the expectation of ultimately receiving compensation for services rendered to RushMore and profit from the sale of timber to RushMore, and the Commissioner has suggested no competing motivation. Certainly, actual realization of the motivating economic remuneration need not occur during such period of time as realization is precluded by first mortgage loan restrictions incident to the procurement of financing used for the installation of new facilities aimed at increasing the profit and income to be ultimately realized after elimination of the restrictions. Petitioner would not have caused RushMore to obtain the SBA loan imposing the

restrictions if he did not believe the sacrifice of immediate realization was justified by the expected increase in the ultimate realization.

While the SBA restrictions delayed the time when Petitioner could begin to reap the anticipated monetary benefits, the restrictions did not prevent Petitioner from performing services as an officer of RushMore or prevent Petitioner from engaging in timber transactions with RushMore. Petitioner was president of RushMore from the time of its formation (Ex 5-E), and Petitioner performed services for RushMore (R 47). Neither did the SBA restrictions preclude the Petitioner from engaging in timber transactions with RushMore. Petitioner acquired two Forest Service timber contracts covering 28,000,000 feet of timber and notifed RushMore that he held this timber for purchase by RushMore as needed (R 23, Ex 6 to Ex 5-E). He intended to sell the timber to RushMore at a profit if appreciation in timber values justified a profit (Tr 23-24). However, the SBA required that Petitioner sell these two Forest Service contracts to RushMore at cost (R 47-48) and further required that any additional timber be sold by Petitioner to RushMore at cost (R 52). Subsequent Forest Service contracts were acquired in the name of RushMore to eliminate the paperwork of taking title in Petitioner's name and then selling the timber at cost to RushMore (Tr 33-34), but such practice would have been changed when warranted by prospective removal of the SBA restrictions (Tr 24). RushMore could not have acquired the subsequent Forest Service timber contracts in its own name if Petitioner had not personally furnished the required

performance bonds. In a very real sense, Petitioner supplied this additional timber to RushMore.

In the case of bad debts resulting from loans to a newly formed corporation, it is quite likely that a defaulting corporation will never have generated the monetary remuneration anticipated by the founder. A person who receives none of the monetary remuneration which motivated the creation of his corporation needs a tax break more than one who has enjoyed some of the economic fruits. Tax provisions should not be interpreted in a manner which denies their benefits to those who need them most.

SECOND SPECIFICATION OF ERROR

The Tax Court erred in failing to conclude that no proximate relationship existed between:

(i) Petitioner's advances of $144,968.55 to RushMore; and

(ii) Petitioner's trade or business activities connected with RushMore.

ARGUMENT

Until the Internal Revenue Code of 1954, the only nonbusiness debt exclusion read:

> "...a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business."

A body of case law developed the "proximate relationship" doctrine in determining whether the loss from the worthlessness of a debt was incurred in the taxpayer's trade or business. This nonbusiness exclusion is now paragraph (B) of Sec. 166(d)(2) of the 1954 Code. A new exclusion from the nonbusiness debt definition was added by the 1954 Code in the form of paragraph (A) to Sec. 166(d)(2) which reads:

> "(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or"

The phrase "in connection with" of paragraph (A) added by the 1954 Code is a looser term than "incurred in". Cases considering Sec. 166(d)(2) of the 1954 Code have applied the proximate relationship doctrine without specifically consider-

ing whether the degree of relationship is less exacting under paragraph (A) than under paragraph (B).

A proximate relationship exists between a loan and the economic motivation for the loan. This is confirmed by Weddle v. Commissioner (2nd Cir. 1963) 325 F.2d 849, the leading post-Whipple decision on the proximate relationship doctrine involving the business vs. nonbusiness characterization of loans made by stockholders to a controlled corporation. The question considered in Weddle was whether trade or business considerations must furnish the "primary" motivations, or whether it is sufficient that the debt be "significantly" motivated by the taxpayer's trade or business even though there is a nonqualifying motivation as well. Weddle held that "significant" trade or business motivation is enough.

In Weddle, as in most other cases involving loans by stockholders to controlled corporations, the difficulty arose from the competing, nonqualifying motivation attributable to the stock investment. In the case of loans made to an established corporation during a period of economic decline, the nonqualifying motivation is protection of the stock investment. In the case of loans to a new corporation during its formative stage, the nonqualifying motivation is potential dividends and potential gain to be realized from enhanced stock values. Protection of investment was the motivation in Weddle, and the Tax Court expressed the problem as follows (39 T.C. 493 at 496 and 498):

> "During the years in issue, petitioner wore two hats, one as president and general manager of the company for which she received a substantial salary, and two as a major shareholder of a corporation with her daughter owning the remaining stock. The question which we have before us is to determine what hat petitioner wore the day she endorsed the corporate notes which she subsequently was called upon to partially pay."
>
> .....
>
> "...In the absence, however, of scales sufficiently sensitive to be able to ascertain the exact percentage of motivations which impelled their respective actions, we look to the main and dominant reason for their actions. In the instant case, petitioner has failed to establish that her dominant reason was to continue her business of being president and general manager rather than to protect her investment."

What if a stipulation of the parties in Weddle had eliminated protection of investment as a motivation for the loans? Then the taxpayer would have been wearing but one hat.

Petitioner did not advance $144,968.55 to RushMore without economic motivation. To use the terminology of Weddle, the economic motivation may be a qualifying or nonqualifying one. The stipulation and the Tax Court findings eliminate the receipt of dividends and realization of gain from stock investment as a nonqualifying motivation for Petitioner's loans. Sometimes the interest rate may motivate a loan. This is a nonqualifying motivation unless the lender is in the loan business. Petitioner's loans were not motivated by the interest rate which was only 4% in contrast to the 6% rate on the SBA mortgage. With dividends, gain from stock investment and interest rate eliminated as motivation candidates, what remains? No economic benefits have been suggested as motivation candidates other than compensation for services rendered as president

and gain from the sale of timber, both necessitating the conduct of a trade or business for attainment, and both being the subject of extensive activities on the part of Petitioner. These trades or business motivations stand alone without competition from nonqualifying motivations. This supplies the necessary proximate relationship, whether the motivation need be "primary" or merely "significant". Where loans are motivated by trade or business considerations with no competing, nonqualifying motivations, the loans are obviously "created in connection with a trade or business of the taxpayer". Nothing more is required to satisfy the nonbusiness debt exclusion under Sec. 166(d)(2)(A).

In Whipple, the Supreme Court stated that an employee, to establish a proximate relationship between a loan and the business of being an employee, must furnish proof "that the loan was necessary to keep his job or was otherwise proximately related to maintaining his trade or business as an employee". 373 U.S. 193 at 204. The Tax Court cites this statement and observes that Petitioner's stock control precludes any contention he was required to loan RushMore money to keep his position (R 51). The Tax Court ignores the Supreme Court's concluding phrase "or otherwise proximately related to maintaining his trade or business as an employee". As aptly observed in Weddle (325 F.2d 849 at 851):

> "That Mrs. Weddle, unlike Trent, did not have to fear being fired by a superior, is also not at all conclusive as to what she was trying to protect; she would have been fired soon enough if the company had to cease operations through inability to obtain credit - as she was when it ultimately did."

Petitioner's loans were an intrical part of the formation and financing of RushMore. Without the financing, RushMore would have been unable to employ Petitioner as president. Not only did the loans make the job of president possible, but the loans, together with the SBA loans, expanded the scope of the presidency through the enlargement of operations resulting from the addition of the planing mill and dry kilns to augment the sawmill.

Petitioner's loans were likewise proximately related to the business of selling timber. Without the financing augmented by the loans, there was no chance that RushMore could have become a purchaser of timber from Petitioner. Not only did the loans make possible the creation of RushMore as a purchaser, but the loans, together with the SBA loan, increased the quantities of timber which RushMore could purchase through the enlarged operations.

THIRD SPECIFICATION OF ERROR

The Tax Court erred in failing to conclude that a proximate relationship existed between:

> *(i) Petitioner's advances of $144,968.55 to RushMore; and*
>
> *(ii) Petitioner's trades and businesses activities connected with business entities in general or connected with Lelco, Inc. and Lundgren Sales Corporation in particular;*

the Tax Court having recognized that Petitioner's activities in regard to business entities in general, and Lelco, Inc. and Lundgren Sales Corporation in particular, constituted the conduct of trades or businesses.

ARGUMENT

The argument under the preceding specifications of error primarily considered the activities of Petitioner connected with RushMore. Such activities did not comprise the whole of Petitioner's economic life. Petitioner's general occupational background and activities are summarized in the following quotation from the stipulation incorporated in the Tax Court findings (R 17-18, 38):

> "Petitioner has been engaged in the timber and lumber manufacturing business during his adult life. He has conducted this business through partnerships and individual proprietorships. He has also organized, has been and now is an officer of, and has held and now holds substantial stock-

holdings in corporations engaged in the timber and lumber manufacturing and sales business."

It was only natural that such extensive economic endeavors should involve the conduct of some trade or business, and the Tax Court so held in the following key sentence of its opinion (R 50):

> "We agree with petitioner when he states that he was carrying on a trade or business within the meaning of section 166(d)(2), Internal Revenue Code of 1954 (1) by rendering services to corporations as an officer and employee of corporations, (2) by selling timber to various entities for profit, and (3) by operating a sawmill and manufacturing lumber at his plant in Sisters, Oregon."

In the above quotation, the Tax Court correctly expresses the scope of Petitioner's trade or business. As there related, Petitioner was carrying on a trade or business by rendering services to corporations as an officer and employee of corporations, and by selling timber to various entities for profit. When explained in these general terms without limitation to any particular corporation or entity, Petitioner's activities in connection with RushMore are just as much within the scope of such trades or businesses as Petitioner's activities in connection with Lelco, Inc. and Lundgren Sales Corporation. The Tax Court erred in subsequent portions of its opinion which limit the above correct statement of Petitioner's trade or business by reference to particular corporate entities.

Creation of a new corporate employer and creation of a new purchaser for timber would augment and expand the trade or business of rendering services to corporations and selling timber to entities. Coverage of Sec. 166(d)(2)(A) requires only that the debt be created "in connection with a trade or business of the taxpayer". Petitioner's loans were an intrical part of RushMore's formation and development. After correctly recognizing that Petitioner was engaged in the business of rendering services to corporations as an officer and employee, and engaged in the business of selling timber to various entities for a profit, the Tax Court erred in failing to hold that loans essential to the formation of a new corporate employer and a new corporate purchaser of timber were loans created "in connection with" such trade or business.

Even if the scope of the trade or business in which Petitioner was engaged is limited to rendering services as an officer and employee to Lelco, Inc. and Lundgren Sales Corporation, and limited to the selling of timber to Lelco, Inc., such limitation does not preclude the establishment of a proximate relationship between such trade or business and the loans to RushMore. When a taxpayer is engaged in the business of rendering services to two corporations as an officer and employee for compensation, and engaged in the business of selling timber to one corporation at a profit, loans incident to the formation of a new employer and a new purchaser of timber are still loans made "in connection with" such trades or businesses.

FOURTH SPECIFICATION OF ERROR

The Tax Court erred in expressing doubts as to whether Petitioner's advances of $144,968.55 created a genuine indebtedness rather than equity contributions.

ARGUMENT

The reasons stated by the Tax Court for doubting whether Petitioner's advances created a genuine indebtedness (R 49) indicate that the Tax Court is advancing a warmed over version of the thesis which this Court emphatically rejected in Taft v. Commissioner, 314 F. 2d 620 (9th Cir. 1963). There, the taxpayer, Taft, transferred business assets of $106,931.82 to his majority owned corporation in exchange for an unsecured, noninterest bearing demand promissory note in the amount of $106,931.82. Operating losses had previously exhausted paid-in capital, so the only assets of the corporation after the transaction consisted of the $106,931.82 in assets received from Taft, offset by the $106,931.82 note to Taft, giving the corporation a zero net worth. Emphasizing the zero net worth, the Tax Court held the consideration for Taft's note was placed at the risk of the business, and concluded therefrom that the note represented an equity rather than a creditor interest, John S. Taft, 20 CCH Tax Ct. Mem. 1135 (1961).

There was no equity cushion in Taft, and the $106,931.82 consideration for Taft's promissory note was put at the risk of the business in that the corporation would be unable to pay

the note to the extent the amount realizable from the corporate assets was diminished by subsequent operating losses and decrease in asset value. Obviously, no outside source would have made an interest free advance of $106,931.82 to Taft's corporation. If placing funds at the risk of the business, or inability to obtain funds from an outside source, are controlling factors in determining the debt vs. equity issue, this Court would have sustained the Tax Court in Taft rather than holding that the Tax Court's denial of debt recognition was clearly erroneous.

All of the Tax Court's doubts concerning the genuineness of Petitioner's advances relate to why no outside source would have made the loans, and highlight the comparative risk of Petitioner's advances over the secured position of the SBA. Petitioner's advances were placed at the risk of the business in that RushMore would be unable to pay the notes to the extent operating losses and decrease in asset value reduced the net amount realizable from the corporate assets below the $125,000 equity capital. This risk is no different and no greater (if as great) than the risk assumed by Taft under his $106,931.82 note.

Petitioner and Taft were willing to make advances upon terms which would repel an outside source because of motivations not possessed by an outside source. Taft had a collateral motivation by virtue of his continuing interest in the transferred assets through his majority common stock

ownership. As stated under the preceding specifications of error, Petitioner's motivation was not the 4% interest rate, but was the trade or business motivation of receiving compensation for services rendered and profit from the sale of timber to RushMore when elimination of the SBA restrictions permitted. A corporation would not be exploiting the potential of the situation if it accepted conventional loan terms from a person expecting to derive collateral economic benefits. The fact that collateral considerations motivate a person to advance funds upon more liberal terms and at greater risk than would an outside source merely confirms the potency of the collateral motivation. It does nothing by way of disproving an intent to create an indebtedness and attain the attributes of a creditor.

Intent has always been the touch stone of this Court's approach to the debt vs. equity issue. Taft v. Commissioner, supra, at 623, footnote 1, citing Wilshire & W Sandwiches, Inc. v. Commissioner, 175 F.2d 718 at 720 (9th Cir. 1949); Maloney v. Spencer, 172 F.2d 638 at 641 (9th Cir. 1949). When a transaction is highly documented and the instruments involved are conventional in form with no ambiguities, the best evidence of the intent of the parties is the manifestation thereof

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5 Taft also may have had trade or business motivations. Presumably, he received a compensation from the corporation for services rendered. The issue in Taft was whether payments upon the note should be taxed as a dividend, not whether the note was created in connection with Taft's trade or business.

contained in the instruments, at least where the supplementing documentation and the conduct of the parties do not disclose an intent contrary to that manifested by the instruments.[7]

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6 In Kraft Foods Company v. Commissioner (2nd Cir. 1956) 232 F.2d 118 at 123, the Court states that the vast majority of debt v. equity cases involve "hybrid securities" - instruments which have some of the characteristics of the conventional debt and some of the characteristics of the conventional equity. When such hybrid securities are involved, a problem of characterization is one of considering each case on all of its facts, but when the instruments involved are conventional in form and contain no ambiguity on the face, the intent is determined by the objective manifestation thereof in the instruments. This portion of Kraft Foods Company is quoted with approval in the recent case of United States v. Snyder Bros. Co. (5th Cir. 1966) ___F.2d___; 66-2 USTC para 9573.

7 Wilbur Security Company v. Commissioner (9th Cir. 1960) 279 F.2d 657, and O. H. Kruse Grain & Milling v. Commissioner (9th Cir. 1960) 279 F.2d 123, are cases in this category where conduct conflicted with the documentation.

In Wilbur Security Company v. Commissioner, the promissory notes bearing a fixed rate of interest and definite maturity dates were executed representing obligations that had been in existence for a long number of years prior thereto upon which varying amounts had been paid by the corporation rather than a fixed rate. This Court rejected the taxpayer's contention that only the circumstances existing in the tax years involved should be examined. Rather, this Court held the facts for the subject years alone would not truly portray the actual relationship (279 F.2d at 662). In the instant case, the documentation commences with the formation of RushMore.

In O. H. Kruse Grain & Milling v. Commissioner, supra, no payments were made upon the promissory note until a Revenue Agent questioned the transaction a number of years after the due date. Bookkeeping entries inconsistent with debt recognition were explained as "mistakes", and the taxpayer did not appear as a witness. Although the Tax Court's opinion in Taft relied heavily upon Wilbur Security Company and O. H. Kruse Grain & Milling, this Court made only brief reference to Wilbur Securities Company.

Promissory notes in conventional form subordinated only to a first mortgage loan strongly indicate an intent on the part of the promisor and promisee to create an indebtedness.[8] Petitioner's advances of $144,968.55 were evidenced by promissory notes conventional in form subordinated only to the SBA first mortgage loan. Other documentation of the transaction, such as the SBA loan application (Ex 5-E) and SBA loan authorization (Ex 7-G) refer to Petitioner's advances as loans. A RushMore balance sheet prepared by an SBA representative shows Petitioner's advances as liabilities, not as capital stock (Ex 6-F). While mere labels do not control tax consequences,

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8 Subordination to a first mortgage creditor has never been raised as an obstacle to debt recognition. Even subordination to all general creditors, existing and future, (Both as to principal and interest) is not fatal to debt qualification, as held in the leading case of Commissioner v. O. P. P. Holding Corp., 76 F.2d 11 (2nd Cir. 1935). Gilbert v. Commissioner, 248 F.2d 399 (2nd Cir. 1957) cites Commissioner v. O. P. P. Holding Corp., supra, as an example of permissible variation from classic debt. The recent case of United States v. Snyder Bros. Co. ___F.2d___ (5th Cir. 1966); 66-2 USTC, para 9573 recognizes that Commissioner v. O. P. P. Holding Corp., supra, represents the law on the effect of subordination but distinguished the fact situation on the grounds that the particular subordination provisions in Snyder Bros. Co. rendered the holder of the debentures "practically helpless" to enforce any rights as contrasted to the situation in O. P. P. Holding Corp., and Snyder Bros. Co. emphasized the lack of a restriction on payment of dividends during the period of subordination, such a restriction being present in O. P. P. Holding Corp. Here, Petitioner's notes were not subordinated to general creditors, the notes were fully enforceable upon demand after retirement of the SBA loan having a six year maturity, and the SBA loan agreement (Ex 12-L) prohibited RushMore from paying dividends or making any distributions upon or in redemption of its stock while the SBA loan was outstanding, a period co-extensive with the subordination of Petitioner's notes.

uniformity of terminology consistently applied in the documentation of a transaction certainly helps to ascertain the actual intent. This is particularly true when the terminology is employed by a reputable third party such as the SBA having no self serving motivation for the terminology.

Manifestation of Petitioner's creditor intent concerning the $144,968.55 is not limited to the legal effect of the notes and the "loan" terminology. The forecast of cash receipts and disbursements attached as Exhibit 5 to the SBA loan application (Ex 5-E) projected repayment of Petitioner's advances in full by May, 1957 without reference to profits. When the SBA shortened the requested first mortgage term from ten to six years, and required subordination of Petitioner's advances, Petitioner altered his intent only to the extent required by the SBA condition. There is no indication that Petitioner made a complete about face and intended the $144,968.55 as an indefinite commitment to equity capital. Petitioner's intent is reflected in an offering circular filed by RushMore with the Securities & Exchange Commission as part of a Regulation A registration (Ex 47-AU). After reciting Petitioner's common stock interest in RushMore, the offering circular contains the following statement at the bottom of page 6:

> "In addition, Leonard Lundgren holds $144,968.55 of notes of issuer, and Lelco, Inc., an Oregon corporation, holds a $15,000.00 note of issuer, all to be paid after settlement of the Small Business Administration obligation under a standby agreement.

This confirms Petitioner's intent to have his advances paid as

soon as possible after elimination of the SBA subordination without limitation to profits.

An additional note of realism is supplied when attainment of a creditor's attributes requires the giving up of equity benefits. This Court observed in Taft that the $106,931.82 note resulted in no additional voting power for Taft and no change in his proportionate equity interest. Here, Petitioner's advances did not increase his voting power nor change his proportionate equity interest in RushMore. An increase in Petitioner's voting power would have given Petitioner and his wife the ability to vote more than two-thirds of the stock. A two-thirds vote is required under South Dakota law for mergers, consolidations and sale of assets, so an increase in Petitioner's voting power to two-thirds had meaning. Instead of taking this benefit which would have resulted from an additional stock interest, Petitioner sought the attributes of a creditor in regard to the $144,968.55, the right to receive payment as soon as possible after retirement of the SBA loan, and the right to share with general creditors.

Duplicating the approach it took in Taft, 20 CCH Tax Ct. Mem. 1135 (1961), the Tax Court ignores all the individualized manifestations of intent, and applies the objective standards of whether an outside source would make the advances, and whether the advances were put at the risk of the business to a greater extent than the Tax Court deems proper under its version of prudent corporate financing. While such objective tests may have some evidentiary value in the absence of individualized manifestations, or in cases where the individ-

ualized manifestations give conflicting indications, the objective tests cannot override the preponderance of evidence that Petitioner's advances were intended to constitute and did constitute genuine indebtedness. Failure of the Tax Court to recognize Petitioner's advances as genuine indebtedness would be clearly erroneous if the question is one of fact, rather than a question of law or a mixed question of law and fact. Since the intent is documented in written instruments, the question seems to be one of law which this Court may decide, rather than remanding the case to the Tax Court for further proceedings on the debt vs. capital issue consistent with the law of this Circuit.

CONCLUSION

For the reasons set forth above, this Court should reverse the decision of the Tax Court and allow the $129,000 business bad debt deduction claimed by Petitioners for 1961.

Respectfully submitted,

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CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of The United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

William H. Kinsey

William H. Kinsey

Of Attorneys for Appellants

APPENDIX

Exhibit No.	Offered	Identified	Received
1-A through 47-AU	3	3	3